

## APPENDIX

FOMC Notes -- Peter Fisher

DECEMBER 20, 1994

Mr. Chairman,

I will be briefly addressing two major points:

First, the improved market sentiment toward the dollar; and,  
Second, the pressure on the Mexican peso.

Since the Committee's 75 basis point increase in rates at its last meeting, the dollar continued to gain in value, rising 1.9 percent against both the mark and the yen, with increasingly positive market sentiment. However, since the start of December, when the dollar reached its period highs of 1.5835 marks and 100.73 yen, the dollar has traded sideways in narrow ranges. .

Perhaps the best reflection of the dollar's relative strength, and of the change in sentiment, was the initial period of consolidation just above 1.57 marks and 100 yen. Over several days, the dollar traded uneventfully through a series of events which, had they occurred three or six months ago, would have been quite likely to cause sharp declines. These included: the resignation of Secretary Bentsen and the supervisory action with Bankers Trust, as well as the oscillations of the yield curve associated with year-end position adjustments and with Orange County.

From a European vantage point, the dollar's quiet, firm trading through these events implied a degree of dollar strength not seen for some time.

In the last week or so, as the dollar has been unable to resume any upward momentum, market participants have pointed to:

the mark's strength within Europe;

the decreasing likelihood that the Bundesbank will be able to maintain the plausibility of any further rate decreases; and,

the diminishing expectations that the Committee will act to raise rates today,

all as reasons for taking profits on the dollar's November rally. Overall, however, the dollar's resilience is still noteworthy.

The Canadian dollar declined by over two percent against the U.S. dollar over the period [1.3639 to 1.3945], as their market seemed to respond with disappointment to the Bank of Canada's effort to avoid matching U.S. rate increases basis point for basis point. Thus, while the Bank of Canada has raised its target range for overnight rate by 50 basis points over the last five weeks, three-month Canadian rates have backed up by over 100 basis points.

Throughout the period, the Mexican peso has been under pressure, trading at or near the Bank of Mexico's internal limit against the dollar --

As a result, the Bank of Mexico began intervening, for the first time since July, and has sold over over the period, of which

were sold on Friday and

were sold yesterday.

The events and announcements associated with the inauguration of the Zedillo administration have not had the hoped-for effect of overshadowing the increased tensions in Chiapas, the growing anxiety about the prospects for political reform, and impact of rising U.S. rates. Indeed, the very expectation that the inaugural events might be sufficient to overcome these negative factors has accentuated the market's disappointment, putting further pressure on the peso in thinning, end-of-year markets. In the current environment, market participants appear to have decreasing appetites for Mexican investments whose risk-return prospects are declining relative to those of other countries. We expect some announcement this morning from the Mexican authorities of a change in their exchange rate regime. The market is full of rumors. We are not certain at this point what the nature of the change will be, whether it will be a discrete adjustment in the bands or a float of some kind.

Mr. Chairman, while we had no intervention operations during the period, I would like to inform the Committee that we have completed the annual renewal of the swap lines with our European and Japanese counterparts. (The Canadian and Mexican arrangements come up for biannual renewal in December 1995.)

I would be happy to answer any questions.

Notes for FOMC Meeting  
December 20, 1994  
Joan E. Lovett

Open market operations during the intermeeting period were aimed at implementing and maintaining the increased degree of reserve pressure adopted at your meeting on November 15, consistent with Federal funds trading around 5 1/2 percent. You recall that, at the time, the borrowing allowance was left unchanged because the full rise of 75 basis points in the discount rate was allowed to show through to reserve markets. Since then, the allowance has been reduced by \$100 million, in two steps, as seasonal borrowing fell. It now stands at \$125 million. Adjustment borrowing was again quite light on most days but jumped at the end of two maintenance periods when money market conditions tightened up. For the intermeeting period, adjustment borrowing averaged \$65 million.

The start of the interval saw fairly large reserve shortages, primarily the consequence of the buildup in currency ahead of the holiday season. These needs were expected to rise another notch in the period currently underway as a result of continued growth in currency and an elevated Treasury balance following the mid-December corporate tax date.

Actual reserve needs over the interval as a whole were reduced modestly as a result of revisions to operating factors. Individual revisions were sometimes substantial but, on balance, their effects were mostly offsetting.

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Both outright and temporary operations were used to meet the large reserve deficiencies. We bought about \$4 1/4 billion of Treasury coupon issues in the market at the end of November. This was our sixth market purchase of the year, and the fourth for coupons. We also took in another \$1 1/4 billion of securities through intermittent purchases from foreign accounts. For the year to date, our holdings of Treasury securities have now grown by \$33 billion, an expansion on a par with each of the preceding three years.

Temporary operations were used to fill in remaining gaps. Altogether since your last meeting, we arranged seven multiday System RPs and five operations lasting one business day. Multiday RPs were arranged ahead of the coupon pass, and again in the current maintenance period with the further deepening of reserve needs. In the middle period, an accumulation of factor revisions after the coupon pass eventually left us in temporary oversupply. We wound up absorbing reserves on two occasions towards the end of that period after the surplus became apparent.

In the upcoming reserve maintenance period which covers the year-end, reserve shortages are expected to grow further as currency jumps one last time before receding. We anticipate that a sequence of large multiday RPs will be necessary to meet deep deficiencies and the high demands for excess reserves that often arise around the year-end.

Funds traded with a very firm bias on several days during the interval, even when some of the factors that typically generate heavy payment flows were absent. Trading on the December 7 settlement date was a particular surprise. Our own estimates pointed to a substantial reserve surplus, even after allowing for the modest-sized draining operation we arranged that day, and this was reflected in a low funds rate in the morning. But the rate soared as high as 20 percent in later trading as the demand for excess reserves apparently was well above even the elevated level we had allowed for. For the interval as a whole, the effective funds rate averaged 5.56 percent.

In securities markets, the yield curve flattened dramatically further over this past--relatively brief--intermeeting period. Rates on shorter-term Treasury coupon securities and some bills jumped by over 50 basis points, on balance. These rates were driven upwards by a combination of economic considerations and technical developments. Longer-term yields, meanwhile, dropped by as much as 20-25 basis points. Thus, the coupon yield curve was about 75 basis points flatter at about 30 basis points. The momentum behind the flattening reached a point where it became almost self-reinforcing, but it has eased off in more recent trading sessions. While participants had anticipated a continued flattening trend, many were caught off guard by the speed with which the recent move occurred and the level which it ultimately reached.

The 75 basis point hike in reserve market rates was a more aggressive policy move than was generally anticipated. The market initially reacted somewhat tentatively and seemed to be groping for appropriate levels. The move was seen as demonstrating that the Fed was prepared to act decisively to contain upward price pressures and, thus, this policy action proved to be a key component in the psychology behind the curve flattening as the period unfolded.

The climb in shorter-term rates over the period was strongly supported by a steady stream of economic indicators that pointed to continued robust growth. Labor markets showed signs of tightening further, and buoyant measures of consumer confidence were reflected in available information about spending during the holiday season. Most market analysts now place fourth quarter real GDP growth in a 4 to 5 percent range with the momentum expected to extend into next year. Meanwhile, the general absence of visible price pressures at the final level helped to hold down longer-term yields, although analysts have noted that many of the more advance price indicators continue to flash warning signals.

The immediate catalyst behind many of the often abrupt rate moves that occurred during the period was a restructuring of financial portfolios, responding in part to the accumulation of interest rate increases over the past year. A wave of selling in equities early in the period was accompanied by some move into longer dated Treasury securities, which were seen as offering



relatively more attractive returns. A number of financial entities reportedly restructured portfolios by liquidating or hedging their exposures to a further rise in interest rates, which often involved heavy selling of short- or intermediate-dated securities. With the year-end approaching, some of this activity was motivated by a desire to realize losses in an already disappointing year rather than carry forward unprofitable positions.

The unraveling of the Orange County California investment pool was felt in a variety of markets. When word of the fund's financial plight broke, the prospect of a massive liquidation of its holdings pressured shorter-term rates higher. Not long afterwards, dealers began selling the collateral supporting the reverse RPs extended to the fund. The fund held both "plan vanilla" and structured agency notes, and spreads of agency paper widened. There was also an initial jolt in the market for municipal debt on fears that other municipalities could be facing problems similar to Orange County's.

While this episode has yet to be fully played out, the fallout to date appears to be relatively contained. The disposal of the pool's assets has, from a market standpoint, proceeded fairly smoothly, despite the large amounts involved and some of the legal questions raised along the way. Of course, the initial sales have been of the more marketable paper and this aided the distribution. The municipal market quickly stabilized, and large-scale outflows from bond funds have thus far not

materialized. Perhaps the greatest effect has been to reinforce the uneasiness that exists in most markets that there may be other financial land mines yet to come to light.

With the year-end coming into view, the markets are thinning out, and the kind of year it has been is making for even thinner conditions than usual. While there is some caution about how things will turn out, the market for now seems to be approaching the year-end calmly. Trading volumes for end-of-year financing have been limited, and quotes for funds over year-end range between 7 and 8 1/2 percent, with some foreign names paying towards the higher end.

As for the Fed, investors see monetary policy on a clear tightening trajectory. However, expectations about near-term policy adjustments are not as easy to decipher because of the many flows that have had an impact on some of the usual rate indicators. Few market analysts expect the Committee to act as soon as today. The prevailing sense seems to be that the larger move in November and the shorter period between meetings may stay the Fed's hand for a spell. The latest round of favorable aggregate price indices, and some of the recent volatility in financial markets are seen as supporting this view. Still, while most don't expect a move, few would completely rule it out. An interim rate adjustment via an asymmetric directive is also seen as a real possibility, and the next step, whenever it comes, is not expected to be the last.

E. M. Truman  
December 20, 1994

FOMC Presentation -- International Developments

In putting together the Greenbook projection for this meeting, we were in the uncomfortable position of having no comprehensive data on developments in the U.S. external sector for the current quarter. This morning, with the release of October data on nominal U.S. merchandise trade in goods and services, we received our first hard data.

As noted in the exchange market report in front of the Committee, the October deficit on goods and services was \$10.1 billion and the deficit on goods alone was \$15.0 billion. Compared with the average of the third quarter, the overall deficit widened somewhat, while the trade deficit increased by more modestly. The percentage increases in exports and imports were the same -- about 1-1/2 percent. However, compared with September, imports in October rose while exports edged off somewhat, primarily as the result of reduced aircraft shipments.

A downward revised deficit on goods trade in September combined with the more substantial upward revision in the estimated surplus on services for the third quarter as a whole that was released last Wednesday suggest an upward revision to net exports of goods and services for the quarter. We estimate that the revisions will add about 3/10ths to the growth of real GDP at annual rate.

- The data released this morning for October are essentially in line with the Greenbook forecast for the fourth

quarter. They tend to confirm our outlook for continued strong growth in exports. That growth will be sustained by the ongoing expansion of economic activity in our major trading partners at an average annual rate of about 4 percent and, to a lesser extent, by the effects of the weakening of the dollar, on balance, this year.

A reasonable question is why we are not projecting a further pickup in growth in the major foreign industrial countries next year. One answer is that there are risks to our forecast in both directions. We are expecting faster growth in some countries that will be offset by slower growth in Germany, the United Kingdom, and Canada. In Germany, a major cause is tighter fiscal policy, in particular the income tax surcharge that takes effect on the first of January. In the United Kingdom, tighter fiscal policy combines with tighter monetary policy to slow growth. In Canada, policy restraint is also a factor, but the major influence is the projected slowdown in the U.S. economy.

While our forecast contains an upside risk for foreign growth and, therefore, for our projection of exports, one would be hard pressed to argue that the surprise might be of the magnitude that we have experienced this year -- more than a percentage point and a half. Moreover, the magnitude of the surprise this year has moved actual output much closer to our estimates of potential in most of the foreign industrial countries. The gap is now projected to narrow further over the projection period. If foreign authorities share our analysis and

believe that the attendant risks to inflation have increased substantially, monetary policies abroad could well turn out to be more restrictive than we have assumed in our forecast.

On the import side, we continue to project a substantial slowing in growth after the first quarter of next year particularly in the volume of non-oil imports excluding computers; the expansion of imports of computers should slow but remain at hefty double-digit rates. The principal driving force in our outlook for imports is the slower growth of U.S. economic activity, although effects of the lower dollar also are expected to play a role.

A final word on the dollar, a perennial risk to our forecast. As you know, the dollar has appreciated on average in terms of other G-10 currencies by about 5 percent from its low point in early November, including a couple of percent since the mid-November FOMC meeting. We are projecting that the dollar will remain at essentially its current level throughout the forecast period. Over the next couple of quarters, we expect that the dollar will be sustained by moves by the Federal Reserve to contain inflation. Further along, short-term interest rates abroad are expected to start rising while dollar rates are unchanged or declining. One question is what will be happening to nominal and expected real long-term interest rates here and abroad. Real long-term rate differentials could turn against the dollar, but in our forecast we have assumed that they will be essentially unchanged.

Mike Prell will now continue our presentation.

Michael J. Prell  
December 20, 1994

FOMC BRIEFING

Unlike Ted, I don't have anything hot off the presses to report. However, we did receive a couple of pieces of information last week, after the Greenbook was completed, and they might warrant a few words. I say that because they highlight areas of considerable importance, and uncertainty, in our forecast.

The first piece of news related to business inventories in October. Stocks were up substantially, outside of the auto sector, with the pace of accumulation running only a little below that of the third quarter.

Forecasting inventory behavior is a perilous activity, as the experience thus far this year has illustrated once again. But there's no way to duck the issue, and we've staked a good deal in our projection on firms wanting to build their stocks at a good clip through the opening months of 1995, and then seeking to curtail their accumulation fairly promptly once sales show signs of decelerating. A deviation in one direction or the other from this pattern could appreciably alter the dynamics of the economy in the next several quarters.

The risks obviously are two-sided. Conceivably, some of the accumulation in recent months has been motivated by the desire to ensure adequate holiday season stocks or by efforts to beat expected price increases--for example, for steel. Under the circumstances, inventory investment might drop off more quickly next year. But, given that the aggregate stock-to-sales ratio remains relatively low in our forecast, and supply conditions relatively tight, it is

possible that the current wave of desired inventory accumulation could prove more persistent than we're anticipating. If that were so, it might delay one of the key forces behind our projection of a marked slowing in GDP growth in the latter half of 1995. That would put even greater weight on the shoulders of the more direct demand-damping effects of higher interest rates. And, as you know, signs of such effects have been scarce to date.

In that regard, the housing data reported on Friday are worthy of note. Housing starts jumped 7 percent in November, reaching their highest level since last December's spike. The increase was evenly split between single-family and multifamily starts. Clearly, one would have to question whether there is much restraint in train if the most interest-sensitive component of expenditure is still showing such buoyancy. Given our forecast of a significant near-term weakening in final demand, I don't find these data especially comforting.

However, I'm not willing to throw in the towel on our analysis, either. First, permits slipped a touch last month in the key single-family category--and that is a less volatile indicator. Moreover, it is less susceptible to weather effects. We thought that the mild weather in some parts of the country in November might give us a blip in building, and the regional data are consistent with that interpretation. Finally, the latest anecdotal information--including the December Homebuilders survey--points to a weakening in activity. Given these considerations, I would characterize the November starts data as suggesting only a mild upside risk to our forecast.

Obviously, judging the distribution of risks regarding the outlook for demand is key to your policy decision today. This is especially so if you share our view that the pressures on productive

resources already have reached levels that presage an early upturn in inflation, albeit a gradual one. As you know, the most recent data on wages and on consumer prices have been favorable. And there is at this point no definitive indication that the acceleration in prices that has been so evident at the crude and intermediate materials levels is about to be mirrored in retail prices.

However, we believe it would be a mistake to conclude from the recent good numbers that a pickup in inflation is not at hand. Broad pressures on manufacturing capacity or on labor supplies are a quite recent phenomenon. And, as I've noted previously, the fact that the economic conditions are such that we would expect only a gradual acceleration in prices--one that would amount to less than a tenth of a percentage point per month of additional increase--means that the signals could be lost in the month-to-month noise. Experience suggests that these are circumstances in which one's convictions about the basic situation could be severely tested; in the late Eighties, for example, the initial phase of the pickup in inflation was difficult to discern and it misled us--and others--into thinking for a while that the natural rate of unemployment might be lower than we had previously thought.

That said, we have, nonetheless, recalibrated our inflation projection somewhat in this forecast round. Despite the higher output path and lower unemployment rates in our current projection, the outlook for the level of inflation is more favorable. We are still predicting a quarter-point pickup in core CPI inflation next year, but it is now only to 3.2 percent, rather than 3.4 percent. The slightly higher path of the dollar, and a somewhat lower near-term oil price are factors in this change. But more important is the fact that we have seen inflation come in lower than expected this year, and we have



made a commensurate level adjustment to our forecasted inflation rates.

Mr. Chairman, I have resisted the temptation to reiterate fully the analysis in the Greenbook. In a nutshell, we believe that the continuing strength of the economy has pushed resource utilization rates beyond sustainable levels, and it appears likely that substantial further tightening action will be needed to prevent the projected near-term step-up in inflation from evolving into a significant upward trend. Some of you expressed concern at the last meeting about the very low growth rates we were projecting. This remains a feature of the current forecast. Does this imply a risk of recession? Yes, it probably does. But, given where the economy is now and seems to be headed in the short run, we see that risk may be unavoidable if the Committee wishes to keep inflation firmly in check.

December 20, 1994

FOMC Briefing  
Donald L. Kohn

The situation facing the Committee at this meeting would seem to have an eerie familiarity: The economic data have been surprisingly strong, labor and capital resource utilization has risen further, and, as a consequence, the staff has increased its estimate of how much tightening the Committee needs to do to reduce pressures on resources enough to keep the inflation rate from climbing steadily higher. In the circumstances, my briefing as well risks an eerie familiarity, and in the spirit of holiday giving, I will be short.

The greenbook noted the reasons for thinking that additional policy firming was needed to relieve inflation pressures. In fact, the market has built into the term structure of yields more tightening than in the staff forecast. Even so, the consensus of outside forecasters is that inflation will be somewhat higher than it has been for the last few years--not only next year, but over the longer-run as well. After the Committee's last action, real interest rates may be slightly to the restrictive side, judging from historical experience. However, even more restraint may well be needed to avoid a lasting uptick in inflation--not only to counter the effects on aggregate demand of increased

credit availability, strengthening growth abroad, and earlier declines in the dollar, but also to overcome the effects on inflation of operating for a time beyond potential. Moreover, innovation and deregulation in credit markets have reduced liquidity constraints, and to achieve the same degree of restraint, real rates may have to be higher now for a time than in earlier decades--especially before 1980. With the economy already producing beyond its likely long-run potential, and in the absence of any signs of slackening in aggregate demand, the risks would seem still be tilted toward higher inflation in the absence of additional firming.

If the Committee were convinced that further tightening were needed, prompt action, even at today's meeting as under alternative C, would be appropriate. In these circumstances, waiting to tighten won't help move the economy toward the Committee's objectives, and could even hurt in terms of risking a deterioration in inflation expectations in financial markets and in the economy more generally. A near-term move would build on the effects of November's action in demonstrating the Committee's commitment to maintaining low or declining inflation, and its assessment that the economy did not seem to be on a path that would produce those results.

But, in some respects, the situation facing the Committee has changed from that of the last half year, and

these changes may give the Committee some reasons for, and scope to, postpone further tightening, as under alternative B, at least for a little while. For one, after the unusually large firming of November, and with real rates probably at higher levels, the Committee may want to see more than one month's additional data to assess whether policy is beginning to bite before taking further action.

In addition, as both Peter and Joan pointed out, financial markets seem to be more confident now that the economy will slow and inflation will be fairly well contained. The partial recovery of the dollar, the flattening of the yield curve, and the leveling out of some commodity price indexes in the last few weeks suggest expectations that policy will be at least somewhat successful. Of course, some of these responses are predicated on significant further policy tightening, but the change in attitude does mean that market reactions--for example the rise in the dollar--are reinforcing the thrust of policy. This shift in attitude may reduce any urgency to take further steps to tighten immediately, though the new attitudes could turn out to be fragile if there were additional adverse information bearing on the inflation outlook.

Finally, nervousness in financial markets about where capital losses may reside, along with concerns about showing clean statements at year-end, raise the possibility of a flight to quality over the next few weeks. Somewhat

wider risk premiums and greater care in extending credit would be a welcome adjunct to monetary policy restraint in working to foster less ebullience in borrowing and spending. Moreover, a further tightening is unlikely to precipitate an abrupt or destabilizing market adjustment. Still, the odds of market disruption from tighter policy will be even smaller after year-end.

If the Committee saw these factors as arguing for a pause in tightening and the adoption of alternative B, it might want to consider whether to accompany that choice with an asymmetric directive. The period to the next meeting is only 6 weeks. But if the Committee viewed the risks still as strongly tilted toward one side, it might not want to wait until the period was over if the data becoming available in the first half of January continued to suggest unsustainable strength, especially if that were accompanied by a pickup in inflation. A prompt reaction to such data would convey the Federal Reserve's continuing resolve to contain inflation and hence might forestall any developing tendencies to raise inflation expectations.